Profile of the Economy

[Source: Office of Economic Policy, Office of Financial Analysis]

Real gross domestic product

Growth in real GDP slowed in the second quarter of 1997 from a very rapid rate in the first quarter. The initial estimate of second quarter growth was 2.2 percent at an annual rate, although more recent data suggest that the figure may be revised upward. Growth is still likely to be well below the strong 4.9 percent pace of the first quarter.

The slowdown was led by a sharply reduced pace of consumer spending, which edged up at just a 0.8 percent annual rate in the second quarter compared with a rapid 5.3 percent gain in the first. Consumer spending on goods actually fell, led by a drop in motor vehicle purchases, but continued strong growth in consumer expenditures for services offset the decline in goods. Deterioration in the net export trade deficit also held down growth, and inventory investment was lower than in the first quarter.

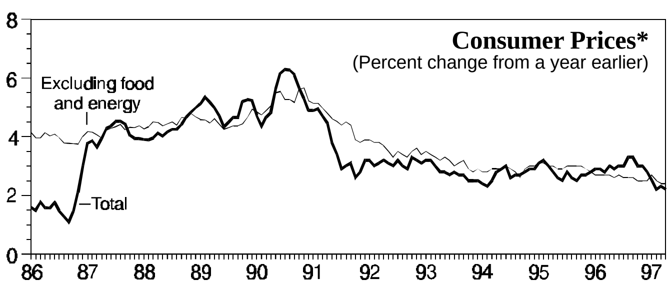
In contrast to these weaker elements, business fixed investment surged in the second quarter, particularly for equipment. Investment in new capital equipment rose by more than a 20 percent annual rate, the second-fastest rate of growth in almost 14 years. Purchases of computers led the way, as falling prices boosted real values.

Inflation remained well contained in the second quarter. The chain-weighted price index for GDP rose at a 1.4 percent annual rate, while the domestic purchases index, which subtracts exports and adds imports to get a measure of prices paid by U.S. residents, edged up just 0.6 percent at an annual rate. This was the lowest quarterly rate since 1961, and reflected not only well-behaved domestic prices but also lower prices for imports due to the strong dollar.

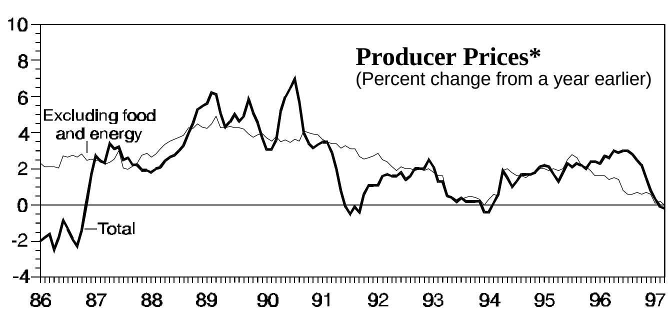
Consumer and producer prices

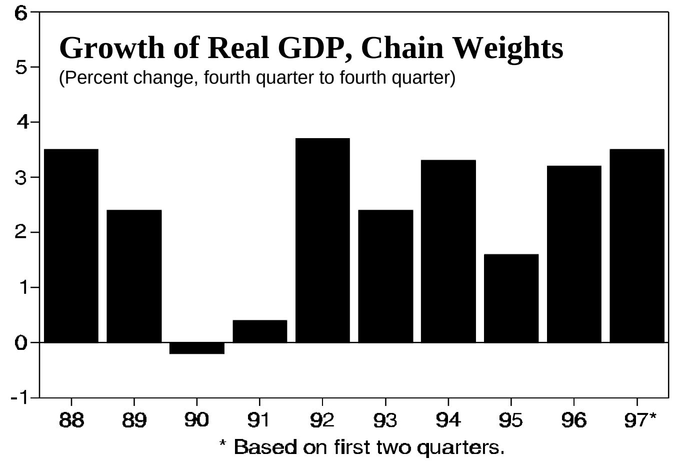
Inflation has remained favorable thus far through 1997. Food and energy prices have moderated following some acceleration last year, while ‘‘core’’ inflation, which excludes the volatile food and energy components, also remains well contained.

The consumer price index (CPI) rose by 1.5 percent at an annual rate through the first seven months of 1997, well below the 3.3 percent increase during 1996. Food and energy prices were responsible for much of the deceleration, reversing course so far this year after rising sharply last year. The core CPI advanced at a 2.4 percent pace through July. This was slightly lower than the 2-3/4 percent averaged during the previous 3 years and well below the pace of the early 1990’s.



*Year tick marks correspond with June data.





Declines in food and energy prices at the producer level have resulted in seven consecutive monthly decreases in the producer price index (PPI) this year, with the index down by a record 3.1 percent annual rate. On a core basis, finished goods prices have fallen by a rate of 0.5 percent in the first seven months. If that downward trend continues, this would be the first year that core producer prices have fallen in the history of the series, which began in 1974.

The cost of compensating labor, which typically rises when labor markets are tight, remained moderate in the first half of 1997. The employment cost index rose 2.8 percent at an annual rate during the first two quarters, little different from the 2.9 percent increase last year. A slight speedup in the growth of wages and salaries was offset by a slowdown in benefit costs.

Real disposable personal income and consumer spending

Real disposable (after-tax) personal income rose at a 3.0 percent annual rate in the second quarter, well below the 4.6 percent pace in the first. Much faster growth in wages and salaries and in dividend income accounted for part of the faster rate in the first quarter. Cost-of-living adjustments to Social Security and other transfer programs in January also boosted income that quarter.

Growth in real consumer spending also slowed in the second quarter after a bulge in the first quarter. Spending rose at a rapid 5.3 percent annual rate during the first quarter, then slowed abruptly to only 0.8 percent in the second quarter. Unusually mild winter weather accounted for part of the shift in spending into the first quarter that normally would have occurred in the spring.

The share of after-tax income devoted to personal saving rose to 4.2 percent in the second quarter from 3.7 percent in the first, which had been lowest quarterly rate in 3 years. In 1996, the personal saving rate averaged 4.3 percent.

Industrial production and capacity utilization

Industrial production in manufacturing, mining, and utilities has grown at a 3.1 percent annual rate through the first 7 months of 1997, following an increase of 4.3 percent during all of 1996. This is substantially above the 1.1 percent gain registered during 1995.

Manufacturing production, which accounts for about 86 percent of industrial production, has risen at a 3.2 percent rate since last December. Within manufacturing, the production of computer equipment has shown big advances. Production of motor vehicles and parts has declined on balance so far this year; however, excluding motor vehicles and parts, durable manufacturing has maintained steady growth. Output of nondurables has been sluggish.

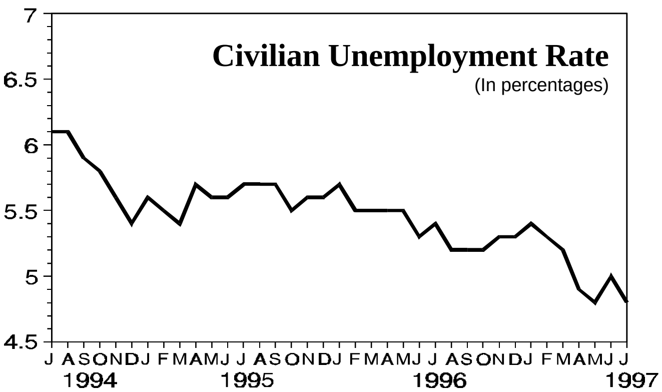
Moderate growth of industrial output this year has not kept pace with the 3.9 percent rate of expansion in capacity. As a result, the industrial capacity utilization rate fell to 83.1 percent in July from 83.5 percent in December. Currently, the rate is about 1-3/4 percentage points below the peak rate for the current business cycle expansion of 84.9 percent around the beginning of 1995, although it is still above the long-term average of 82.1 percent.

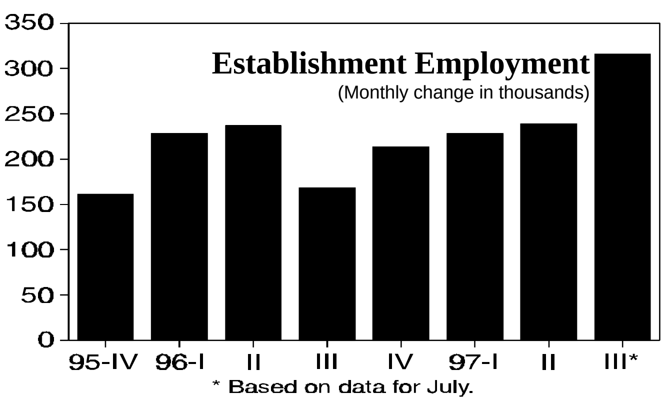
Employment and unemployment

The labor market remains very strong. Job growth accelerated this year from the 1996 pace and the unemployment rate has fallen to levels not seen since 1973.

Increases in jobs on nonfarm payrolls averaged 246,000 per month in the first seven months of this year, above the 216,000 per month average in 1996. Job growth in July was a very large 316,000, up from 228,000 in June. While part of the speed-up reflected seasonal adjustment problems in the government sector, private sector job growth was still a strong 260,000. In the first half of the year, private sector jobs rose an average of 213,000 per month.

The unemployment rate dipped to 4.8 percent in July, matching the May figure as the lowest since late 1973. The share of the working-age population that is employed edged up to 63.8 percent, only fractionally below the all-time peak reached in May. These indicators show that the economy continues to operate at a very high level of labor utilization.





Average hourly earnings of production and other nonsupervisory workers were unchanged in July at $12.23. Growth in hourly wages over the past twelve months was 3.6 percent, down a bit from the twelve-month growth rates posted earlier in the year.

Nonfarm productivity and unit labor costs

Nonfarm business productivity (real output per hour worked) rose at a 1.0 percent annual rate over the first half of 1997, following a 1.2 percent increase during all of 1996. These results were in line with the long-term trend growth rate of 1.1 percent and represent a marked improvement over the prior 3 years, when on balance there was no growth.

Hourly compensation costs in the nonfarm business sector rose at a 3.8 percent annual rate during the first half of 1997. Labor costs per unit of output in the nonfarm business sector, which combine the impact of growth of compensation with that of productivity, were up by a 2.8 percent annual rate so far this year, compared to an increase of 2.1 percent during all of 1996. The 1997 rate of advance suggests that inflationary pressures remain moderate.

Productivity in manufacturing, included in the nonfarm business sector, grew at a 2.8 percent annual rate over the first half of 1997, after a 3.9 percent increase during all of 1996. Unit labor costs in manufacturing are up by a narrow 0.6 percent annual rate so far this year, following a 0.8 percent decline during 1996.

Current account balance

The current account is the broadest measure of U.S. transactions with the rest of the world, covering not only trade in goods and services but income flows as well. The current account shows a deficit, which deepened in recent years from a low of $5.7 billion in 1991 to around $130 billion in 1994 and 1995 and $148 billion in 1996. The deepening reflected in large part the faster pace of U.S. economic growth compared with growth for most of our major trading partners. This brought in imports at a more rapid rate than the rate of growth of exports. In addition, the balance on investment income has dwindled as the inflow of capital into the United States has boosted payments of earnings and interest abroad.

The current account deficit of $148 billion in 1996 represents a substantial downward revision from the previous estimate of $165 billion, owing to a number of improved methodologies and particularly to major data revisons from the Treasury's Benchmark Survey of Portfolio Investment Abroad. This survey collected data on U.S. holdings of foreign stocks and bonds and permitted a substantial upward revision in estimates of the income these holdings produce. The 1996 deficit, though still large, was $19 billion below the all-time peak deficit in 1987. The deficit changed little relative to GDP in the last 3 years. It amounted to 2.0 percent of GDP in 1996, which was much below the 3.0 to 3.6 percent share of GDP tallied during the 1985 through 1987 period.

The widening deficit in 1996 reflected a large deterioration in the balance on goods and a smaller deterioration in the balance on investment income. In contrast, the surplus in services trade improved. This pattern continued in the first quarter of 1997, when the deficit on trade in goods widened further--partly owing to unwinding of temporary factors from the final quarter of last year--but the goods deficit narrowed somewhat in the second quarter as capital goods exports remained strong while the price of oil imports fell back. The balance on goods and services was a sizable drag on real GDP growth in the first quarter but this drag was reduced in the second quarter, despite continued strong growth of imports in response to income growth.

The balance on investment income also continued to deteriorate in the first quarter of 1997, turning negative from a small positive balance for 1996 as a whole. Data on income flows in the second quarter are not yet available. Interest payments on the rapidly growing foreign holdings of U.S. Treasury securities have been a major factor in income flows. Foreign investors have been attracted to these securities by favorable interest rate differentials, the safe-haven role of the dollar, and the wish of many countries with sizable current account surpluses to accumulate these assets.

Exchange rate of the dollar

The dollar began to appreciate in the middle of 1995 and continued through 1996. It has accelerated so far in 1997. Based on the Federal Reserve Board's trade-weighted index of the dollar against G-10 currencies, the dollar had risen by 8.4 percent by the end of 1996 from the all-time low reached in April 1995. By July, the dollar had risen a further 9.9 percent.

Most of the dollar deterioration in 1994 was against the yen and the deutschemark, and the improvement has also been greatest against these currencies although the behavior has been quite disparate recently. Between April 1995 and this past December, the dollar rose by 36 percent against the yen and by 12 percent against the deutschemark. By July, the dollar had risen an additional 15 percent against the deutschemark but, after rising an additional 10 percent against the yen through April, it fell by 8 percent in the subsequent three months.

The trade-weighted index of the dollar in July was just above its recent high of January 1994. Many factors determine the level of exchange rates in international currency markets. Underlying economic fundamentals in the United States are sound and confidence in the dollar is high.

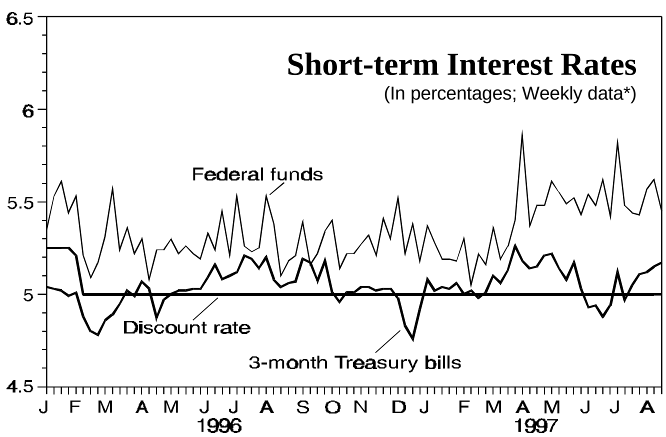
Interest rates

Short-term market interest rates have increased a bit since June and long-term rates, which declined steadily from April through July, turned up again in August.

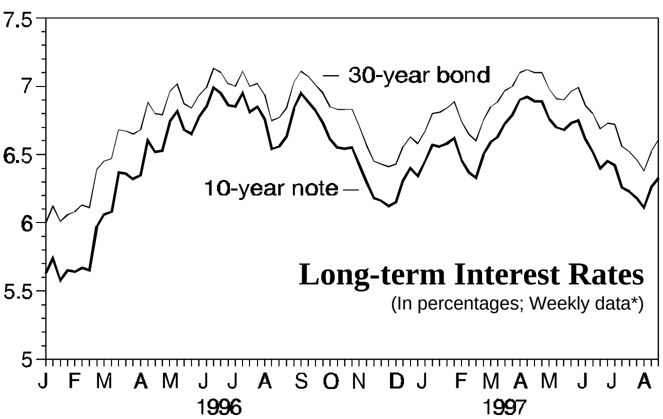
The Federal Reserve Board has left monetary policy unchanged since raising the Federal funds rate target by one-quarter of a point in March to 5.50 percent. The Board indicated that they took the action in light of persisting strength in demand, which was raising the risk that inflationary imbalances might develop. That was the first change in monetary conditions since late 1995 and early 1996 when the Federal Reserve eased short-term interest rates in two quarter-point increments.

Long-term interest rates eased between April and July, but in August moved up slightly. The yield on the 30-year Treasury bond, which topped 7 percent in April for the first time since last September, declined to a recent low of just under 6.4 percent at the end of July. In early August that rate increased slightly to about 6.6 percent.

Mortgage interest rates have exhibited a similar pattern. The rate for a 30-year fixed rate conventional loan was above 8 percent in April but since then has fallen to about 7.4 percent. Mortgage rates have remained favorable for the past 3 years. They were one of the factors contributing to growth in the housing market.



*Average for week ending Friday; Federal funds ending Wednesday.



Net national saving and investment

Net national saving, which excludes depreciation to replace worn-out or obsolete equipment and structures used in production, edged up to 6.8 percent of net national product (NNP) in the first quarter of 1997 from 6.4 percent in 1996 and as low as 3.4 percent in 1992. Despite the gains, net saving remains only about half as high as the 12.1 percent of NNP averaged in the 1950's and 1960's.

Recent improvement is mainly the result of the significant narrowing of the Federal deficit, which has reduced government dissaving to 0.3 percent of NNP in the first quarter of 1997 from 1.1 percent last year and a weak 4.7 percent in 1992. Private saving (of households and businesses) was equivalent to 7.1 percent of NNP in the first quarter, considerably below readings exceeding 10.0 percent in the 1960's and 1970's.

Net domestic investment equaled 8.0 percent of NNP in the first quarter, up from a low of 4.9 percent in 1991. Foreign inflows were equivalent to 2.1 percent of NNP in the first quarter, or about one-quarter of domestic investment. U.S. sources provided investment equivalent to 5.9 percent of NNP, only about half the share averaged in the 1950's and 1960's.

Housing

Housing activity was slow for several months following an unseasonably large surge in February, but it picked up again in early summer. Underlying fundamentals have been very favorable, such as strong job and income growth, record levels of consumer confidence, and low mortgage interest rates.

Starts of new homes averaged 1.46 million units at an annual rate through the first seven months of the year. This is down a bit from the 1.48 million units in 1996, the best year for home building since 1988. Starts of single-family homes have not shown much growth this year, while the smaller multi-family market continues on its modest upward trend.

Sales of new single-family homes have outpaced starts, leading to a sharp reduction in the inventory of unsold new homes on the market. Sales of new homes rose to over 800,000 units at an annual rate in four of the first six months of this year, well above the 1996 total of 756,000, the highest annual total in 18 years. Sales of existing homes have also been strong, averaging a 4.1 million-unit annual pace so far this year after topping the 4 million mark in 1996 for the first time since that series began in 1968.

Rapid growth in employment and income and very favorable readings of consumer confidence fueled the expansion in the housing market in 1996, and these trends have continued into 1997. Low mortgage interest rates have also helped to support a high level of activity.

Federal budget deficit

The Federal budget deficit is on track to show a large decline in fiscal 1997. Through the first ten months, the deficit totaled just $37 billion, $64 billion less than the same months in fiscal 1996. This would mark the fifth straight year that the deficit has decreased since reaching an all-time high of $290 billion in fiscal 1992.

Strong economic growth and passage of the Omnibus Budget Reconciliation Act of 1993 set the deficit on its downward course. The fiscal 1996 deficit of $107.3 billion was the lowest in 15 years. As a share of GDP, the deficit was 1.4 percent that year, the smallest share since 1974. If the deficit holds its downward course through the remainder of fiscal 1997, it would represent just 0.5 percent of GDP.

Receipts have been exceptionally strong so far in fiscal 1997 due to expansion in the labor market, higher incomes, and rising corporate profits. Through the first ten months receipts were almost 9 percent higher than in the previous fiscal year. Outlays, in contrast, were a modest 3.2 percent higher than in the same months of fiscal 1996.

Further deficit reduction is expected over the next 5 years. The Balanced Budget Agreement reached between the Administration and Congress will continue to trim the Federal deficit until budget balance is reached in 2002.